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Negotiable Instruments—Holder in Due Course—Good Faith: Subjective or Objective?—Westfield Inv. Co. v. Fellers

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The chain of litigation is not a rapid conduit, but rather there are defenses and estoppels along the way which could prevent recovery to any one litigant in the chain. It was these very defenses as embodied in the Code which persuaded the court in the instant case to adopt the view disallowing any right to the drawer against the collecting bank.[17] As a court of first impression, it concluded that the assertion of the defenses of the drawer,[18] the collecting bank,[19] and the other rights and defenses between the transferors and transferees[20] would be difficult if the court allowed this suit by the drawer.

This decision clearly adopts a view which gives no right of action to the drawer, but more important than its following this line of authority is the fact that the court here sets forth some sensible reasons for the rule. This is a welcome change from the cases which, in adopting this rule, have merely told the drawer that he should have sued his own bank.[21]

EDWARD J. MCDERMOTT

Negotiable Instruments—Holder in Due Course—Good Faith: Subjective or Objective?—*Westfield Inv. Co. v. Fellers.*[1]—Plaintiff finance company furnished conditional sales contract and promissory note forms to a seller of frozen food and home freezer plans. The body of the conditional sales contract contained an assignment clause which in bolder type described the finance company as the specific assignee of the seller's contract rights. On the reverse side was a place designed for representations by prospective purchasers as to their financial condition, for the purpose of securing credit from the finance company. At one time the note and contract forms were a single sheet of paper separated by a perforated line. The seller fraudulently induced defendants to purchase a food and freezer plan. Defendants executed a promissory note and conditional sales contract but upon discovery of the fraud they refused to make any payments. After repossession and sale, the finance company, as assignee of the note and contract, sued for a deficiency judgment of $1,420.75. Defendants introduced

tion of § 3-419(1), upon which the plaintiff relied for his conversion count, on the ground the defendant was not a "payor bank" as defined in § 4-105(b). It also recognized that although the collecting bank may be liable in conversion to a proper party, subject to denfenses, e.g., under § 3-419(3), there was no explicit provision within the Code which determined to whom the collection bank was liable. Thus the drawer's right of action must be found outside the Code.

17 "The enactment of the Uniform Commercial Code opens the road for the adoption of what seems the preferable view." 1962 Mass. Adv. Sh. at 1273, 184 N.E.2d at 362.

18 UCC §§ 3-406 & 4-406.

19 UCC § 4-406(5).

20 UCC §§ 3-417 & 4-207.

21 It has been indicated that a court in a jurisdiction which has allowed a cause of action to the drawer against the collecting bank may still do so in spite of UCC § 4-406(5). Clarke, Bailey & Young, Bank Deposits and Collections 165 (1959); Bailey, Brady on Bank Checks 512 (3d ed. 1962).

1 74 N.J. Super. 575, 181 A.2d 809 (1962).

no evidence that plaintiff lacked actual good faith or had knowledge of the particular fraud at the time of the assignment, but did claim the defenses of fraud in the inducement and failure of consideration. HELD: Judgment for defendants. The finance company, by its actions and knowledge of the situation prevailing here and in similar freezer deals, and by furnishing its selected seller with an instrument which, for all practical purposes, could be negotiated only to itself, became so inextricably a part of the particular freezer deal with defendants that it cannot later claim the protection of a holder in due course *in good faith.*

Careful scrutiny of the facts is essential to an understanding of the decision. The finance company had engaged in a series of similar transactions with the seller, supplying the blank forms and purchasing the completed notes and contracts from the seller shortly after the sale. This provided necessary credit to the seller enabling it to carry out its operations and provided a profitable investment for the finance company. The seller and several other organizations involved in the fraudulent food and freezer deals were located in Wayne, New Jersey, "miles away"[2] from the finance company in Westfield, New Jersey. Despite the court's implication to the contrary, there was no finding that the finance company had actual knowledge of the fraudulent scheme and consequent lack of subjective good faith. The court used the following evidence to impute lack of good faith to the finance company:

(a) That as a dealer in this paper it must have known that "reprehensible practices in the sale of these freezers had become a matter of public, judicial and legislative concern;"[3]

(b) That a single constable operating in Wayne had repossessed 300 to 500 freezers a year. The court felt this was

> . . . evidence of a prevailing situation which should have served to put the plaintiff on its guard to inquire of its own constable, if he was Westfield's, or of the dealers, or of the defaulting purchasers to discover the reason for these amazing defaults.[4]

There was no finding that the constable mentioned was Westfield's, or that all the repossessions were made by or on behalf of Westfield, or that the repossessed freezers were originally sold by the seller here involved, or financed by Westfield;

(c) That the finance company supplied the note and contract forms, as discussed above. The note on which this action was founded was apparently an ordinary promissory note no different in form from the thousands which pass in commerce every day.

None of these factors is more than "suspicious circumstances" and is not evidence tending to show actual knowledge or lack of subjective good

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[2] Id. at 590, 181 A.2d at 818.

[3] Id. at 590, 181 A.2d at 817.

[4] Id. at 590, 181 A.2d at 818.

faith. Thus the court, in precluding the finance company from holder-in-due-course status, has used a purely objective test for good faith.[5]

Although this case was decided under the Uniform Negotiable Instruments Law (NIL),[6] the court quoted from the Uniform Commercial Code (UCC), section 3-302(1),[7] thereby implying that the result under the Code would have been the same, *i.e.*, that the test for good faith is objective under either statute.

In so holding the court has departed from prior New Jersey decisions construing the NIL, which adopted the subjective good faith test for a holder in due course.[8] Although the court did attempt to avoid the effect of

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[5] The court seems to disclaim use of an objective (suspicious circumstances) test when it states (id. at 584, 181 A.2d at 814) that

> . . . present day commercial practices require that the court inquire in a particular case as to what facts constitute more than 'merely suspicious circumstances' affecting the 'good faith' of a holder in due course.

But the evidence relied on is nothing more than a series of suspicious circumstances and is not the equivalent of a finding that the finance company had knowledge of or took part in the fraudulent transaction with defendants. This is evident from the court's conclusion (id. at 590-91, 181 A.2d at 818):

> Westfield Investment Company, not only by its actions and knowledge of the situation prevailing here and in similar freezer deal transactions but also in delivery to its selected dealer of an instrument which, for all practical purposes could be negotiated only to it, became so inextricably a part of the original transaction with the purchaser that it could not thereafter stand aloof in the role of a holder in due course *in good faith.* (Emphasis by the court.)

[6] The applicable sections are the following: N.J. Stat. Ann. (1937):

> § 7:2-52. A holder in due course is a holder who has taken the instrument under the following conditions:
>
> . . .
>
> III. That he took it in good faith and for value;
>
> IV. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it. [NIL § 52.]
>
> § 7:2-56. To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith. [NIL § 56.]

[7] Id. at 585, 181 A.2d at 815. The UCC became effective in New Jersey January 1, 1963. UCC § 3-302(1) states in part:

> A holder in due course is a holder who takes the instrument . . .
>
> (b) in good faith; . . .

Good faith is defined in UCC § 1-201(19) as:

> honesty in fact in the conduct or transaction concerned.

[8] Driscoll v. Burlington-Bristol Bridge Co., 8 N.J. 433, 86 A.2d 201 (1952); Rice v. Barrington, 75 N.J.L. 806, 70 Atl. 169 (1908); Joseph v. Lesnevich, 56 N.J. Super. 340, 153 A.2d 349 (1959). The court in the *Driscoll* case, interpreting NIL § 59, supra note 6, states at 480, 86 A.2d at 224:

> our courts have consistently adhered to and frequently quoted the rule expressed in Rice v. Barrington . . . :
>
> > . . . proof of circumstances calculated merely to arouse suspicion will not defeat recovery on a negotiable note taken for value before maturity. Bad faith, *i.e.*, fraud, not merely suspicious circumstances, must be brought home to a holder for value whose rights accrued before maturity, in order

these decisions, the attempt failed as no evidence of anything other than suspicious circumstances was unearthed,[9] certainly not the "bad faith, *i.e.*, fraud . . ." required by *Rice v. Barrington*.[10]

The court's assumption that an objective test for good faith was incorporated into Section 3-302(1) of the UCC seems equally questionable. As originally drafted, section 3-302(1)(b) required "observance of the reasonable commercial standards of any business in which the holder may be engaged."[11] Pennsylvania, which, like New Jersey, had previously applied a subjective test for good faith,[12] originally enacted the section in that form[13] and the Pennsylvania Bar Association stated: "The requirement of the observance of the reasonable commercial standards of a business changes the law from subjective good faith, by adding an objective test."[14]

However, the provision for "reasonable commercial standards" was omitted in later versions of the UCC,[15] due largely to the studies made by the New York Law Revision Commission, and Pennsylvania amended its statute accordingly.[16] The memorandum submitted to the Law Revision Commission by counsel for the Chase National Bank clearly illustrates the basis for objection to an objective test:

> [I]n this most important aspect of commercial paper the code either expressly or through the ambiguity of the 'reasonable commercial standards' phrase in 3-302 definitely opens the prospect of a return to the doctrine of *Gill v. Cubitt*[17] which . . . resulted in such discredit of Bank of England bills on the European continent and complaints of the mercantile community, as to lead subsequent English courts and the NIL itself to adopt the doctrine of good faith and actual notice.[18] (Footnotes added.)

> to defeat his recovery on a negotiable note upon the ground of fraud in its inception or between the parties to it.

See 2d Report, New Jersey Commission on the U.C.C. 267 (1960).

[9] See note 5 supra.

[10] Supra note 8.

[11] See 1952 Official Draft of the UCC § 3-302(1)(b). This section is quoted in the instant case, supra note 1, at 584, 181 A.2d at 814.

[12] First Nat'l Bank v. Goldberg, 340 Pa. 337, 340, 17 A.2d 377, 379 (1941), where the court stated:

> To defeat the rights of one dealing with negotiable securities it is not enough to show that he took them under circumstances which ought to excite the suspicion of a prudent man and cause him to make inquiry, but that he had actual knowledge of an infirmity or defect, or of such facts that his failure to make further inquiry would indicate a deliberate desire on his part to evade knowledge because of a belief or fear that investigation would disclose a vice in the transaction.

[13] Pa. Laws 1953, ch. 3, § 3-302(1)(b). This was amended by Pa. Laws 1959, ch. 1023, § 3, which deleted the "reasonable commercial standards" language.

[14] Pa. Bar Ass'n Notes, Pa. Stat. Ann. tit. 12A, § 3-302, at 524 (1954).

[15] Supra note 7

[16] Supra note 13.

[17] 3 B. & C. 466, 107 Eng. Rep. 806 (1824). The "suspicious circumstances" test for good faith first laid down in this case was forcefully laid to rest in England only 12 years later by Goodman v. Harvey, 4 A. & E. 870, 111 Eng. Rep. 1011 (1836).

[18] Memorandum of Milbank, Tweed, Hope & Hadley on Article 3 of the UCC,

In a meticulous study of the consequences of the original UCC Section 3-302, the New York Law Revision Commission concluded that under the New York NIL[19]

> . . . the New York courts could conceivably find that a party was a holder in due course, who (a) had subjective good faith, (b) was not guilty of (i) subjective or (ii) objective bad faith, but (c) did not act in such a way that he could affirmatively be said to have had objective good faith. In other words, his conduct might fail to meet the reasonable commercial standards of his business (objective *good* faith), and yet not be so bad as to amount to objective bad faith. . . . But under the 1952 draft of the Code this would not have been possible.[20]

This is as clear a statement as can be found of the underlying factors implicit in the subjective test for good faith—the doctrine of "the white heart and the empty head,"[21] or as it has also been called, the "blundering fool"[22] doctrine. The Commission Report then continues:

> The Supplement No. 1 revision deleting the controversial reference to 'reasonable commercial standards,' eliminates all this controversy and restores to Section 3-302(1)(b) the present N.I.L. language.[23]

In the New Jersey study of the UCC,[24] the following comments appear concerning section 3-302:

> The Code basically seems to follow this 'white heart' (subjective) test of good faith. It does, however, list some suspicious circumstances ('red lights') which prevent a person from becoming a holder in due course, regardless of the actual state of mind at the time he acquired the instrument. These suspicious circumstances are listed in section 3-302(3) of the Code.[25]
>
> . . .
>
> New Jersey follows the 'white heart' or 'subjective' test of

1 Report of the New York Law Revision Commission 198, 204 (1954).

19 The New York statute has provisions substantially similar to §§ 52 and 56 of the NIL, supra note 6.

20 2d Report of the New York Law Revision Commission 904-05 (1955).

21 Note, 53 Harv. L. Rev. 1200 (1940).

22 Schintz v. American Trust & Sav. Bank, 152 Ill. App. 76, 78 (1900), where the court states: "A blundering fool may therefore be found to have acted in good faith, though under like circumstances a shrewd business man might be deemed to have acted in bad faith."

23 Supra note 20, at 907.

24 2d Report, New Jersey Commission on the UCC (1960). In the letter of transmittal to the study the Chairman of the Commission states at p. v:

> In the study that follows there has been collected in one place and for the first time an unparalleled analysis of commercial law and practice. No other of the United States has a more complete collection in one volume of its own commercial law and practice.

The court in the instant case apparently ignored this extensive study. Certainly no reference was made to it.

25 Id. at 266.

> good faith. . . . Therefore, New Jersey law is in accord with the basic notion of 'good faith' set out in section 3-302 of the code.[26]

Thus it is apparent that the court in the instant case has gone against the clear holdings of prior cases in New Jersey and other neighboring states in its construction of Sections 52 and 56 of the NIL,[27] and is inaccurate in its implication that the UCC would require a similar result.

The ultimate reason for this apparent limitation on the *Rice* doctrine is the court's adamant refusal to let the finance company recover against an innocent purchaser in the face of unquestionable fraud and unscrupulous tactics employed by the seller, even though the finance company acted in actual good faith. This fact is apparent from the following statement by the court:

> If it is eager to deal with business firms at all, a financing company should not be permitted to choose carelessly, *without some investigation of the vendor*, or once having had notice of a vendor's unscrupulous tactics, it should not let it pass unnoticed whereby the customer becomes endangered. . . . *If it has chosen carelessly* or has noticed the employment of doubtful business ethics, the financing company should not be allowed to hide behind the holder in due course cloak and thumb its nose at the consumer public. The choice which a financing company exercises should not be a choice devoid of responsibility for its selection.[28] (Emphasis supplied.)

This decision has far-reaching implications, not the least of which is that it directly opposes the manifest legislative intent to further the transferability of negotiable instruments by providing a subjective test for good faith.

Conditional sales, with resultant arrangements between financial institutions and sellers such as here involved, are the backbone of our modern credit economy. If, as this court suggests,[29] so basic a change is required

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[26] Id. at 267.

[27] Supra note 6.

[28] Supra note 1, at 588-89, 181 A.2d at 817.

[29] Id. at 586, 181 A.2d at 815, where the court quotes the following language from the nearly identical case of Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953):

> It may be that our holding here will require some changes in business methods and will impose a greater burden on finance companies. We think the buyer—Mr. & Mrs. General Public—should have some protection somewhere along the line. We believe the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers.

In a note on that and other cases in 34 Ore. L. Rev. 262 (1955) the following appears at 266-67:

> If these cases do not turn on actual notice or a return to the suspicious-circumstances rule, have the courts based their decisions upon a desire to protect someone who is at a disadvantage? This is suggested in the *Martin* case . . . . But this is a dangerous idea. Its adoption would allow the court to become the sole arbiter of the person best able to bear the risk. It would allow the court to decide in each and every case, regardless of the *bona fides* of the holder, who should suffer. This would completely demolish all progress so painstakingly made in the law of bills and notes.

in our policy toward conditional sales in order to protect the innocent purchaser, that change should come from the policy-making body—the legislature—either by a return to an objective test for good faith by adopting the "reasonable commercial standards" language of the 1952 draft of the UCC, or by adopting a Retail Instalment Sales Act.[30] Otherwise, every finance company or other financial institution engaged in furthering conditional sales by such arrangements with sellers will be relegated to the duty of inquiring in each and every case whether the purchaser has any defenses against the instrument, or in the alternative, to taking its chances that there are no defenses.[31] Either way, the financial institution will incur substantially increased expenses, in making inquiry on the one hand, or in costs of litigation and losses on the other, which will undoubtedly be handed down to the consumer in the form of higher finance charges.

In recent years the volume of cases involving this issue has greatly increased. A significant number of jurisdictions governed by the NIL have reached the same result as the court in the instant case,[32] although apparently the issue has not yet come before the courts in any jurisdiction in which the current version of Section 3-302(1)(b) of the UCC[33] was in effect on the date of the transaction.[34] These decisions have been uniformly

[30] See Ill. Laws 1933, § 1, at 716, as amended, Ill. Laws 1955, § 1, at 781; this statute was repealed by the legislature upon the enactment of the UCC, Ill. Ann. Stat. ch. 26, § 10-102 (Smith-Hurd 1961); Symposium, VI. Finance Companies and Banks as Holders in Due Course of Consumer Installment Credit Paper, 55 Nw. U. L. Rev. 389, 396 (1960); Model Retail Instalment Sales Act, § 13, 3 B.C. Ind. & Com. L. Rev. 437, 452 (1962):

> Section 13. Separate Notes.
>
> If, as part of any instalment sales transaction, a note is taken evidencing the instalment buyer's obligations under a retail instalment sales agreement, such note shall refer to the retail instalment sales transaction out of which it arose and any holder of such note shall be subject to all defenses which the instalment buyer may assert against the instalment seller . . . .

See also Note, 34 N.C.L. Rev. 496 (1956), for conclusion that such statutes lack desirable flexibility.

[31] Note, Relation Between Bad Faith and Notice under the NIL, 81 U. Pa. L. Rev. 617, 624 (1933):

> Even though it has been uniformly held that mere suspicious circumstances do not impose the duty of inquiry, under the objective test, there would, in practical effect, be imposed upon the holder such duty of inquiry in every case, for fear that a jury may find that under the circumstances a reasonable man would have had bad faith.

[32] Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940), noted in 53 Harv. L. Rev. 1200 (1940) & 34 Ore. L. Rev. 262 (1955); Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950), noted in 34 Ore. L. Rev. 262 (1955); Mutual Fin. Co. v. Martin, supra note 29; Whitfield v. Carolina Hsg. & Mtge. Corp., 243 N.C. 658, 92 S.E.2d 78 (1956), noted in 34 N.C.L. Rev. 496 (1956). Contra, Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W.2d 657 (1954), reh. denied, 268 Wis. 164, 67 N.W.2d 873 (1955), noted in 39 Minn. L. Rev. 775 (1955).

[33] Supra note 7.

[34] See Hogan v. Metropolitan Food Plan, Inc., no. 881, Munic. Ct. of Phila., Dec. 16, 1958, noted in 33 Temp. L.Q. 114 (1959). This case involved a food and freezer deal and facts very similar to those in the instant case. It arose under Section 3-302(1)(b) of the UCC as originally enacted in Pennsylvania, including the "reasonable commercial standards" test. The court granted the purchaser rescission of the contract on the theory

predicated, as in the instant case, on the fact that the finance company is better able to bear the risk than is the innocent purchaser, the courts thereby ignoring or discarding both precedent and statutory language which require a contrary result. Some cases show clearly that the finance company, in its dealing with the seller, had actual knowledge of the fraudulent scheme.[35] In such an event the UCC unequivocally excludes it from holder-in-due-course status since the subjective test for good faith is not satisfied. But short of a finding of actual knowledge and in the absence of a governing statute, courts should require only a showing of subjective good faith[36] and refrain from decisions, such as that in the instant case, which open the way for a return to the "suspicious circumstances" test of *Gill v. Cubitt*.[37]

FORREST W. BARNES

Negotiable Instruments—Stop Payment Order on a Certified Check—Effect of the Uniform Commercial Code.—*Winston v. Kasper Am. State Bank*.[1]—This action was brought to recover the amount of a certified check. Plaintiff, a real estate broker, was the payee of a check dated August 31, 1956, drawn on and certified by defendant bank before delivery. Instead of cashing the check, the plaintiff instituted an action against the drawer for the full amount of the commission which he believed to be due him. Subsequently, in May 1957, when the drawer learned that the plaintiff was not a licensed real estate broker as required by a Chicago ordinance, he stopped payment on the check and caused an indemnity bond to be posted. The drawer was not a party to the present action but a petition to intervene was filed by the assignee of one-half of the drawer's interest in the security deposit held by the casualty company. On June 30, 1960 the plaintiff

that defendant finance company was not a holder in due course. The author of the note disagreed with the decision even under an "objective test" for good faith.

[35] See G.M.A.C. v. Daigle, 225 La. 123, 72 So. 2d 319 (1954), noted in 53 Yale L.J. 877 (1955).

[36] See note, 33 N.C.L. Rev. 608, 613 (1955), where the following comment appears:

> If, in fact, there is present a situation so fraught with the possibility of fraud or unfairness that the statutory provisions of the NIL are not adequate, then it seems that legislation is the only sound solution. Nothing but uncertainty can arise out of an encroachment upon these statutory provisions by judicial decisions. Undoubtedly this situation presents a ripe opportunity for collusion between unscrupulous finance companies and dealers to take advantage of the buyer. Clearly in some cases the finance company has actually participated in the transaction to such an extent that it cannot be a holder in due course within the statutory provisions. But in other cases there is no evidence of such direct participation in the transaction by the finance company as would charge it with 'actual notice' or bad faith as required by the NIL. In the absence of additional legislation, it is submitted that innocent finance companies that come within the definition of holder in due course under the existing statutes, should not be deprived of that position because of a tendency of the courts to 'catalogue' them in the same class with unscrupulous companies by the indiscriminate or deliberate use of such terms as 'close connection.'

[37] Supra note 17.

[1] 184 N.E.2d 725 (Ill. App. 1962), appeal denied by Sup. Ct. of Ill., Nov. 28, 1962.